



COMMISSION OF THE EUROPEAN COMMUNITIES

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Proposal for a

COUNCIL DECISION

providing exceptional Community financial assistance to Kosovo

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. INTRODUCTION

In June 1999, the Federal Republic of Yugoslavia (FRY) accepted a G8 peace plan and withdrew its forces from Kosovo. Based on UN Security Council Resolution 1244 (1999) of 10 June 1999, the International Community has set up an international security presence (KFOR) and an interim civil administration - the United Nations Interim Administration Mission in Kosovo (UNMIK).

KFOR has been restoring security in the province although the situation remains fragile. Most of the Albanian Kosovar refugees have returned to Kosovo. However, since the end of the conflict many Serbian Kosovars and members of other ethnic minorities in Kosovo have abandoned the province. The demilitarisation of the KLA (Kosovo Liberation Army) and the plans to transform the KLA from a military force into a civilian emergency service corps ("Kosovo Protection Corps") have been finalised.

UNMIK's responsibilities are to establish an international civil presence and to provide interim administrative structures under which the people of Kosovo can enjoy substantial autonomy. Considerable progress has been achieved in recent months in this respect. Headed by the Special Representative of the UN Secretary General (SRSG), Mr Kouchner, UNMIK consists of four components ("pillars") which are humanitarian aid (UNHCR lead), civil administration (UN lead), institution building (OSCE lead) and economic reconstruction and development (EU lead). In his first regulation, issued on 25 July 1999, the SRSG states that "all legislative and executive authority with respect to Kosovo, including the administration of the judiciary, is vested in UNMIK and is exercised by the Special Representative of the Secretary-General." The regulation provides a legislative basis for the exercise of government powers foreseen in Security Council Resolution 1244 (1999).

With the establishment of the Kosovo Transitional Council (KTC), meeting on 16 July for the first time, an initial step has been taken to involve the main political parties and ethnic communities of Kosovo and to create democratic structures. The SRSG has proposed to create four directorates (covering housing, health, education and public utilities) within the KTC and to give it greater responsibility for the administration of Kosovo. The special status of Kosovo however implies a high degree of complexity and a number of important political and legal problems remain to be solved.

On 28 July, a first Donor Conference was organised by the Commission and the World Bank in Brussels to start the process of mobilising funds for the reconstruction and the development of Kosovo. At this Conference, an amount of almost € 2.1 billion of assistance was pledged, of which the Community and the Member States have committed over € 1.1 billion.

Pending the establishment of the European Agency for Reconstruction proposed on 23 June 1999, the European Commission has set up in early July a Task Force in Kosovo (TAFKO) which now numbers some 30 persons. The Task Force is responsible for the implementation of the EC Reconstruction Programme for Kosovo, for which the budget for 1999 is €137 million. Of this amount, a total of € 52 million has been committed to date, in order to cover the most pressing needs. The different programmes cover the areas of housing rehabilitation, village employment and rehabilitation, customs, public utilities, de-mining, rehabilitation of Mitrovica Hospital, support for transport and local administration. Financing proposals for the commitment of the remaining €85 million of the 1999 budget are under preparation.

Another €10 million programme was made available under the 1998 budget. The projects financed under this programme were suspended due to the recent conflict, but are now being reactivated. ECHO (the European Community Humanitarian Office) has responded to the Kosovo crisis in 1999 with so far a total of € 378 million in regional humanitarian aid in favour of the victims.

2. ECONOMIC BACKGROUND AND IMPACT OF THE CONFLICT

The economy of Kosovo, like that of the rest of the FRY, was in poor shape long before the air strikes commenced, because of the increasing international isolation of the FRY as a whole and the slow pace of economic reform there. Aggravating circumstances were the chronically low levels both of public and private investment under which Kosovo suffered particularly since 1989, when Kosovo's autonomy within the FRY was withdrawn, which had provided to the province wide legislative, executive and de facto judicial powers.

Prior to 1989, federal and external sources funding supported the economic activity in Kosovo that increasingly centred on mining and production of raw materials and semi-finished products (accounting for half of the output) while agriculture remained important. However, after the loss of autonomy, industry, mining and infrastructure suffered from a severe contraction due to the massive disinvestment and neglect of operations and maintenance, with total GDP decreasing by 50 per cent until 1995. Since then, industry, dominated by a number of state-owned companies, and mainly privately owned agriculture have accounted each for about a third of GDP, with trade and commercial activities being responsible for the remainder. The rural population has represented more than 60 percent of the total population before the conflict. In addition, a variety of informal activities existed. By 1998, privately owned enterprises were producing some 80% of GDP. Although high uncertainties regarding statistical data need to be underlined, the pre-conflict GDP has been estimated to be in the range of about 400 USD per capita, while national income per capita (including workers' remittances) is estimated to reach approximately double the amount.

As a consequence of the conflict, housing and public facilities in Kosovo have been damaged, particularly in the Northern and Western parts of the province. A preliminary damage assessment commissioned by the European Commission found that 120.000 of 250.000 houses were damaged and put preliminary damage estimates at € 1.1 billion. The telecommunications system has been harmed by the NATO bombings, whereas the other infrastructure and productive assets have rather suffered from neglect, lack of maintenance and cannibalization since the early 1990s as well as from looting and destruction over the last months. The resumption of basic public utilities has been largely achieved and the most urgent repairs are underway. The financing for power sector operations through the winter has been secured with the support of the EU Task Force. The situation in the power, water, and heating sectors remains, however, highly precarious. In the areas of road and rail, activities concentrate on emergency rehabilitation. On 15 October the airport of Pristina was re-opened to commercial traffic. The restoration of the telecommunications system will require several months to show results.

The conflict considerably affected the agricultural sector as regards livestock, agriculture mechanisation, and farm buildings as well as agro-processing infrastructure. The danger of mines has limited the access to farming land. The fall in agricultural and livestock output this year is estimated at roughly 65 percent. Based on the tradition of family-based agriculture, there are, however, good indications that the rural sector can be revived rather quickly.

Following the conflict, production in publicly owned companies (1/3 of which large scale) came almost to a standstill due to an outdated and poor capital stock, ownership questions and an important loss of expertise as the Serb management has largely departed. It is a highly complex situation in legal, political and economic respect if, how and to which extent these enterprises can and shall be revived. Efforts are now being made to resolve these issues in consultation with the Kosovar population and to develop flexible ways to use assets.

The formal financial sector has ceased functioning; banking and payment linkages with the rest of the FRY are severed. After 1989, most banking activities in Kosovo were subjugated to Serbian management and run directly from Belgrade. As a consequence of the conflict, staff has left, records have disappeared or have been destroyed, equipment has been looted and the destiny of deposits seems unclear. Working capital or long-term finance needed is not available. It is likely that a considerable number of the existing banks could face great difficulties in restarting operations soon because of unclear ownership and weak balance sheets as well as lack of capital.

On the other hand, there is clear evidence of level of entrepreneurial skills and strong commitment of the Kosovar population to weather the difficult situation. It is now essential to establish a regulatory and institutional framework for the economic activities that are already carried out.

3. RECENT DECISIONS AND DEVELOPMENTS IN KOSOVO

The EU-led Pillar IV of UNMIK - responsible for economic reconstruction and development - has concentrated in the short-term on keeping the economy going and building a basic macro-economic framework. Pillar IV started to conduct on a policy dialogue with the local population on economic and financial issues through the establishment of an Economic Policy Advisory Board (with working groups on Fiscal Policy, the Financial Sector and Enterprises and Property), which consists of both local experts and experts appointed by UNMIK. Increasingly UNMIK will also tackle the task of guiding the reconstruction effort including the co-ordination of donor assistance.

With respect to the macro-economic framework, Pillar IV, with the support of the IMF and the World Bank, has made considerable progress in the areas of currency, payments, banking issues as well as public finance.

Regulation No. 4, signed on 2 September by the SRSG, legalises the use and possession of any foreign currency in Kosovo. Without being explicit, it recognizes the fact that Kosovo currently is a largely cash-based economy with the deutsche mark being the preferred currency in Kosovo. The implementing Administrative Direction No. 1999/02 stipulates that compulsory payments to authorities, such as customs duties, taxes and fines, shall be paid in DM. For payments in Yugoslav Dinar (YuD), an administrative fee of ten percent of the assessed compulsory payment will be levied to cover handling and transaction costs. Under the regulation, the Yugoslav dinar will retain its legal status and will continue to be used to the extent that businesses and people in Kosovo desire.

UNMIK has worked on designing a modern payments system and a private banking sector. The respective regulations establishing the necessary legal framework are expected to be adopted shortly. A basic payments system is planned to be operational soon using the existing infrastructure of the Yugoslav payments bureau in Kosovo. The regulation exercising the control over payment facilities and services entered into force on 13 October 1999. Banking

activity should begin before the end of the year, with UNMIK planning to issue licenses for such activities. On 16 October UNMIK enacted legislation authorizing lending institutions to make loans to individuals and small business in the territory (Regulation No. 13). By the regulation, institutions, other than banks, can now legally provide micro-credit up to 2,000 DM.

UNMIK also adopted Regulation No. 3 that amends the existing FRY customs law. It introduces a 10% customs rate, varying excise duties and sales tax (15%) on imported goods. The introduction of further simple taxes is foreseen for next year. The tariffs do not apply for trade with Montenegro and Serbia. For the time being, trade with the former Yugoslav Republic of Macedonia (fYRoM) is duty free as under the free trade arrangement between fYRoM and FRY, with an administrative fee of 1% being applied (as well as the excise and sales taxes).

With the support of CAM-K, a customs administration is being established, and on 3 September the SRSG officially opened the first border post of the UNMIK Customs Service at a crossing point with Macedonia (Hani I Elezit/Djeneral Jankovic). A second border post at Vermice/Vrbnica (Albania-Kosovo) has opened on 20 September. By 23 October, a total of almost DM 16 million in revenues had been collected. The opening of a third post at Globocice/Globocica (Macedonia-Kosovo) is now envisaged for mid/late November.

In parallel, Pillar IV is establishing a Central Fiscal Agency (CFA) which will be structured similar to a finance ministry covering the functions budget preparation, treasury, tax and customs administration and collection as well as auditing. It will be under the control of Pillar IV, managed by foreign experts but with a substantial Kosovar professional staff. The related regulation has been signed by the SRSG on 2 November.

With the assistance of the IMF and the World Bank, Pillar IV has developed estimates for the budget numbers for 1999 and 2000. The Kosovo budget essentially continues to be a budget for current expenditure; i.e. the large expenditure items are wages, income transfers and some overhead costs. The underlying assumption is that the public sector will employ in 2000 around 64,000 persons at an average monthly wage of DM 225; however, there are pressures to review this amount upwards.

On the revenue side, the newly introduced customs rates, excise and sales taxes represent the only source of income in 1999. This leaves an estimated budget gap of some DM 77 million (€ 39 million) in 1999 which is unlikely to be completely financed by the some € 33 million pledged at the Donors Conference for this purpose (transition to a civil administration), even if the projected revenue for 1999 were collected as expected (DM 38 million). By September, half of the pledged amounts had been committed to the UN Trust Fund, with the UN generally withholding a 5% administrative fee.

The budget estimate for 2000 assumes a broadening of the tax base by introducing some basic taxes and adjustments to the existing customs arrangement. Projections of revenues presently range between DM 167 and DM 231 million. Based on estimated expenditures of DM 351 million, the most likely shortfall to be funded reaches DM 150 million (€ 77 million). This and the 1999 estimates were presented to and endorsed by the High Level Steering Group for South Eastern Europe (HLSG) in Washington on 28 September 1999. In its statement, the HLSG underlined "that the provision of external budgetary support, fairly shared among donors, is essential to help cover the residual financing needs identified under the budget prepared for Kosovo by UNMIK." It is expected that such support could be secured at the

second Kosovo Donors Conference planned for mid-November at which detailed strategies of economic recovery and reconstruction will be presented.

4. POSSIBLE EXCEPTIONAL COMMUNITY FINANCIAL ASSISTANCE FOR KOSOVO

Given the unfavourable circumstances affecting Kosovo during the last decade (underinvestment, destruction, displacement of persons, etc.) and the need to develop a sound market economy with a view to improving conditions for sustainable development, it will be necessary for Kosovo to obtain external support in the short-term. The IMF and the World Bank have estimated that exceptional external financial assistance of some € 115 million would be needed until end-2000. Only about one third of this assistance has been committed so far.

Kosovo is not in a position to borrow either domestically or abroad. Additionally, in its current status Kosovo is not eligible for membership of the International Financial Institutions. As a consequence, Kosovo may not benefit from conventional IMF- or World Bank supported programmes. However, these institutions continue to monitor the situation closely and provide important technical support to UNMIK.

There is a risk that, if external official assistance in the form of grants was not forthcoming, a rebound of the economy would be jeopardized, with adverse consequences for the already low standard of living. Moreover, basic administrative functions could not be provided. This situation would endanger the recent progress to provide in Kosovo and more generally in the Balkan region, economic social and political stability.

Against this background, it seems appropriate to provide an exceptional Community financial assistance to Kosovo. The Commission is therefore putting forward a proposal for exceptional financial assistance of up to € 35 million in the form of straight grants. This order of magnitude seems appropriate against the overall financing gap for 1999 and 2000. Before submitting its proposal, the Commission has consulted the Economic and Financial Committee, which endorsed the initiative.

The envisaged assistance would be released in at least two tranches. Its effective implementation would be subject to appropriate macroeconomic and structural adjustment conditionality. This would include steps taken by UNMIK to introduce full accountability and transparency in the Kosovo budget.

Proposal for a

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 308 thereof,

Having regard to the proposal from the Commission¹,

Having regard to the opinion of the European Parliament²,

Having regard to the following:

- (1) The Commission has consulted the Economic and Financial Committee before submitting its proposal.
- (2) The Security Council of the United Nations adopted Resolution 1244 (1999) on 10 June 1999 aiming to promote the establishment, pending a final settlement, of substantial autonomy and self-government in Kosovo within the Federal Republic of Yugoslavia;
- (3) The International Community, based on the Resolution 1244 (1999), has set up an international security presence (KFOR) and an interim civil administration - the United Nations Interim Administration Mission in Kosovo (UNMIK);
- (4) UNMIK aims at establishing administrative structures under which the people of Kosovo can enjoy substantial autonomy and to this end has been vested with all legislative and executive powers, including the administration of the judiciary.
- (5) UNMIK is taking steps to involve the main political parties and ethnic communities of Kosovo and its activities;
- (6) UNMIK consists of four components ("Pillars") and the European Union (EU) has taken the lead role³ for the fourth Pillar responsible for economic reconstruction;
- (7) UNMIK, and particularly its Pillar IV, has made significant progress in establishing an economic framework and aims at continuing and enhancing this strategy;

¹ OJ C , , p. .

² OJ C , , p. .

³ International civil presence in Kosovo: Report of the Secretary-General pursuant to Paragraph 10 of Security Council Resolution 1244 (1999), S/1999/672, 12 June 1999, II.5.

- (8) UNMIK is currently establishing a Central Fiscal Agency providing transparent and accountable procedures to manage the Kosovo budget.
- (9) Given the present unfavourable circumstances and on the basis of estimates from UNMIK presented in agreement with the International Monetary Fund (IMF), it will be necessary for Kosovo to obtain external support to establish a sound market economy and a civil administration; it is estimated that exceptional external financial assistance of some € 115 million would be needed until end-2000;
- (10) UNMIK has presented a request for exceptional financial assistance;
- (11) Kosovo is not in a position to borrow either domestically or abroad and whereas it is not eligible for membership of the International Financial Institutions and may therefore not benefit from their conventional support programmes;
- (12) Kosovo is at a low level of development and whereas its GDP per capita is estimated to be one of the lowest in Europe;
- (13) Financial assistance from the Community in the form of straight grants to be made available to UNMIK in support of the Kosovo people is an appropriate measure to help ease Kosovo's financial constraints in the current exceptionally difficult circumstances;
- (14) Without prejudice to the powers of the budgetary authority, the financial assistance will be part of the envelope of aid foreseen for Kosovo in 2000, and therefore subject to the funds being available in the general budget;
- (15) The exceptional financial assistance should be managed by the European Commission;
- (16) The Treaty does not provide, for the adoption of this decision, powers other than those of Article 308;

HAS DECIDED AS FOLLOWS:

Article 1

- 1. The Community shall make available to UNMIK exceptional financial assistance in the form of straight grants of up to EURO 35 million, with a view to alleviating the financial situation in Kosovo, comforting the establishment of essential administrative functions and supporting the development of a sound economic framework.
- 2. This assistance shall be managed by the Commission in close consultation with the Economic and Financial Committee and in a manner consistent with agreements or understandings reached between the IMF and UNMIK or any other internationally recognised authorities of Kosovo.

Article 2

- 1. The Commission is empowered to agree with UNMIK, after consultation with the Economic and Financial Committee, the economic conditions attached to this

assistance. These conditions shall be consistent with any agreement referred to in Article 1(2).

2. The Commission shall verify at regular intervals, in consultation with the Economic and Financial Committee and in liaison with the IMF and the World Bank, that economic policies in Kosovo respect the objectives and economic policy conditions of this assistance.

Article 3

1. The assistance shall be made available to UNMIK in at least two instalments on the basis of a successful completion of the economic policy conditions referred to in Article 2(1). The second tranche shall not be released before two months after the release of the first tranche.
2. The funds shall be made available to UNMIK through the Central Fiscal Agency exclusively in support of the Kosovo budgetary needs.

Article 4

The Commission shall address to the European Parliament and to the Council a report by the end of 2000, which will include an evaluation on the implementation of this Decision

Done at Brussels,

For the Council
The President

FINANCIAL STATEMENT

1. TITLE OF OPERATION

Exceptional financial assistance to Kosovo.

2. BUDGET HEADING(S) INVOLVED

B7-532 macro-financial assistance in favour of Western Balkans.

3. LEGAL BASIS

The forthcoming Council Decision based on Article 308 of the Treaty.

4. DESCRIPTION OF OPERATION

4.1 General objective

Provision of an exceptional financial assistance in the form of straight grants of up to EURO 35 million to UNMIK as Kosovo's external position heavily relies on external financial assistance from official sources, with a view to ensuring the resumption or creation of essential administrative functions in Kosovo.

4.2 Period covered and arrangements for renewal

Until the end of 2000.

5. CLASSIFICATION OF EXPENDITURE OR REVENUE

5.1 Non-compulsory expenditure

5.2 Differentiated appropriations

6. TYPE OF EXPENDITURE OR REVENUE

Straight grant (100% subsidy), which would be released in at least two successive instalments.

7. FINANCIAL IMPACT

7.1 Method of calculating total cost of operation (relation between individual and total costs)

The present estimates by UNMIK Pillar IV, endorsed by the IMF and the World Bank, of Kosovo's total external financing needs from September 1999 to December 2000 amount up to EUR 115 million. A Community contribution of up to

EUR 35 million is proposed in order to cover a substantial part of these needs. The difference is expected to be pledged by other bilateral donors.

The necessary amount will be found inside the envelope of aid foreseen for Kosovo in the 2000 budget, subject to the funds being available in the budget decided by the budgetary authority.

7.2 Itemised breakdown of cost – Schedule of commitment and payment appropriations

EUR million (at current prices)

BUDGET YEAR	2000
Commitment appropriations	35
Payment appropriations	35

8. FRAUD PREVENTION MEASURES

The funds will be paid directly to the Central Fiscal Agency (CFA) of Kosovo, which is under the control of Pillar IV of UNMIK, only after verification by the Commission Services, in consultation of the Economic and Financial Committee and in liaison with the IMF and World Bank Services, that the economic and institutional policy implemented in Kosovo is satisfactory and that the specific conditions attached to this assistance are fulfilled.

9. ELEMENTS OF COST-EFFECTIVENESS ANALYSIS

9.1 Grounds for the operation

By supporting the efforts to organise economic reconstruction and development and to establish a well functioning market economy this assistance would improve Kosovo's prospects of economic recovery and future growth, would help it face the severe economic and social consequences of the period of underinvestment and neglect as well as of the hostilities of this year and for the medium and longer term would lower its dependence on external financing.

9.2 Monitoring and evaluation of the operation

This assistance is of exceptional nature. It will be made available to UNMIK through the CFA only after the adoption and start of the implementation of the regulations stipulating the design of the CFA and its internal control procedures.

The Commission Services in close co-operation with the European Agency for Reconstruction and its predecessor (TAFKO) will monitor and evaluate the action in liaison with the IMF and World Bank

10. ADMINISTRATIVE EXPENDITURE (SECTION III, PART A OF THE BUDGET)

This action is exceptional in nature and will not involve an increase in the number of Commission staff.